

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Vargas Analyst: Marion Mann DeJong Bill Number: AB 2560  
Related Bills: See Legislative History Telephone: 845-6979 Introduced Date: 02/21/2002  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Apportionment of Business Income

### SUMMARY

This bill would make changes to the way California income is calculated for corporations that earn income from multiple states or other countries by:

- changing the standard apportionment formula used to determine the amount of business income taxable by California to a single-factor apportionment formula based on sales,
- requiring certain corporations to use the current three-factor formula based on property, payroll, and double-weighted sales, and
- allowing extractive businesses to choose either the current three-factor formula based on property, payroll, and single-weighted sales, or use the new single-factor formula.

### PURPOSE OF THE BILL

The purpose of the bill appears to be to attract investment to the state by lowering state income taxes for companies with substantial investment in property and payroll in California relative to sales.

### EFFECTIVE/OPERATIVE DATE

This bill is a tax levy. Thus, it would be effective immediately, and apply to taxable years beginning on or after January 1, 2002.

### POSITION

Pending.

### Summary of Suggested Amendments

Amendments are needed to resolve the implementation and technical concerns discussed in this analysis. See "Implementation Considerations" and "Technical Considerations" below.

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
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<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director

Date

Alan Hunter for GHG

03/27/02

## **ANALYSIS**

### **FEDERAL/STATE LAW**

Under existing federal law, corporations organized in the U.S. are taxed on their worldwide income, regardless of source, and are allowed a credit for any taxes paid to a foreign country on their foreign source income. Foreign corporations engaged in a U.S. trade or business are taxed at regular U.S. graduated corporate income tax rates on income effectively connected with the conduct of that business in the U.S.

Under current California law, California source income for corporations that operate both within and without the state is determined on a worldwide basis using the unitary method of taxation. Under the unitary method, the income of related affiliates that are members of a unitary business is combined to determine the total income of the unitary group. A share of that income is then apportioned to California on the basis of relative levels of business activity in the state, as measured by property, payroll, and sales.

As an alternative to the worldwide basis, California law allows corporations to elect to determine their income on a "water's-edge" basis. Water's-edge electors generally can exclude unitary foreign affiliates from the combined report used to determine income derived from or attributable to California sources.

The general apportionment formula, applicable to most corporations, takes into account property, payroll, and double-weighted sales factors. Each factor is the ratio of in-state activity to that same activity worldwide. The taxpayer's apportionment percentage is determined by dividing the sum of the factors by four.

For corporations that derive more than 50% of their gross business receipts from agricultural, extractive, savings and loan, and banking and financial business activities, the apportionment formula is the average of three factors — property, payroll, and single-weighted sales.

Business income is multiplied by the apportionment percentage to determine the amount of income apportioned to this state for tax purposes.

### **THIS BILL**

This bill would replace the three-factor, double-weighted sales apportionment formula used by most corporations with a single-factor apportionment formula based solely on sales. Exceptions to this formula would be provided for two groups:

1. Those that file a combined report, that have a sales factor for the taxable year that is less than the average of their property and payroll factors, and that **fail to meet all** of the following requirements:

- their payroll compensation (excluding stock options) in this state during the taxable year is at least 90% of their payroll compensation during any of the preceding three years;
- their average number of employees *everywhere* during the taxable year is at least 90% of the average number of employees employed in California during any of the preceding three years; and
- their percentage change in payroll compensation (excluding stock options) in California or number of employees in California between the current and preceding taxable year is less than or equal to the same percentage change in each state in which the taxpayer is engaged in business.

In other words, taxpayers that file a combined report and have an average of property and payroll in California in excess of sales would use the single-factor sales formula only if certain employment requirements are maintained. If all of the employment requirements are not maintained, the taxpayer must use the three-factor, double-weighted sales formula.

However, if the employment requirements were not maintained because of natural disaster or other act of God, an act of terrorism, or an action of federal, state, or local government, the taxpayer would use the single-factor sales formula.

2. Taxpayers that derive more than 50% of their gross business receipts from extractive activities would be allowed to choose either the single-factor sales formula or the three-factor, single-weighted sales formula.

The bill would provide that if any part of the apportionment formula provisions is found unconstitutional or is otherwise unenforceable, the remaining provisions would remain in force and effect.

### IMPLEMENTATION CONSIDERATIONS

This bill would raise the following implementation concerns:

- The employment tests for determining which apportionment formula would be used by taxpayers that file a combined report are very complex. In fact, one test would require a two-year, state-by-state comparison of payroll and employees. If taxpayers do not keep their data in a format that supports such a comparison or if they do business in numerous states, this test would be onerous. In addition, developing forms and instructions for the employment tests and auditing them would be difficult for the department.

Further, the tests do not provide for the sale or acquisition of members of a combined group. For example, if a corporation acquired a new subsidiary based outside of California, the next year combined report might include a denominator from the new member, even if the California numerator for the new group was unchanged. Would the new member's payroll from the prior year be taken into account in making the comparison even though that new member wasn't a member of the group in the prior year?

- This bill would allow an extractive business to choose either the single-factor sales formula or the three-factor, single-weighted sales formula. It is unclear whether this is intended to be an election or whether the taxpayer's choice could be changed after original filing, such as upon audit. If it is intended to be an election, the bill should be amended to state that the taxpayer could "elect" which formula to use and that the election must be made on a timely filed original return. In addition, taxpayers could be subject to underpayment penalties if a formula is changed after the tax return is filed.
- This bill defines "taxpayer" as the aggregation of all persons filing a single combined report under Section 25102. General combined reporting authority is provided by Section 25101, which mandates unitary treatment. Section 25102 provides for unitary treatment at the discretion of the Franchise Tax Board. If the author intends for all taxpayers that file a combined report to be subject to the exception to the single-factor sales formula, the reference should be changed to Section 25101. Otherwise, only taxpayers that file a combined report after an audit would be subject to the exception.

### TECHNICAL CONSIDERATIONS

Although the bill retained the definition of "apportioning trade or business," the bill deleted the rules for apportioning trade or businesses (page 4, lines 19 to 28 of the bill). The bill should be amended to reinsert the rules for apportioning trade or businesses.

### **LEGISLATIVE HISTORY**

AB 1642 (Harman, 2001/2002) and SB 1014 (Johnson, 2001/2002) would have replaced the apportionment formula used by most corporations with a single-factor sales formula based. Certain extractive corporations would have been allowed to use a different formula. Both bills died because they failed to pass to the second house before the constitutional deadline.

### **PROGRAM BACKGROUND**

Prior to 1993, California law strictly conformed to the Uniform Division of Income for Tax Purposes Act, which provides for the use of an apportionment formula when assigning business income to a state for tax purposes. This formula is the simple average of three factors: property, payroll, and sales. Each factor is the ratio of in-state activity to that same activity everywhere.

In 1993, California law was amended to double-weight the sales factor. However, certain taxpayers engaged in extractive and agricultural businesses were adversely impacted and objected. To resolve this issue, those taxpayers that derive more than 50% of their gross business receipts from an extractive or agricultural business are provided an exception to the use of the double-weighted sales factor and are instead required to use a single-weighted sales factor in the apportionment formula.

In 1994, the exception to the use of the double-weighted sales factor was expanded to include taxpayers that derive more than 50% of their gross business receipts from savings and loan, banking, or financial business activities.

The requirement for double-weighting the sales factor reflects a determination that sales represent a more significant contribution to a taxpayer's net income than the other two factors. Incidentally, double-weighting the sales factor shifts some tax burdens to companies with large sales in California relative to their investment in property and payroll, and reduces the tax burdens of corporations that have made substantial investment in property and payroll in California relative to sales.

## OTHER STATES' INFORMATION

*Florida, Massachusetts, Michigan, Minnesota, and New York* all use an apportionment formula based on property, payroll, and sales. The sales factor is more heavily weighted than the other two factors for all of these states as indicated in the table below. *Illinois* uses an apportionment formula based entirely on sales. Some of these states provide special apportionment formulas for specific industries. *Massachusetts* uses an apportionment formula entirely based on sales for defense contractors, manufacturers, and mutual fund service corporations. The laws of these states were reviewed because of similarities to California's income tax laws.

	Property Factor	Payroll Factor	Sales Factor
California	25%	25%	50%
Florida	25%	25%	50%
Illinois*	--	--	100%
Massachusetts	25%	25%	50%
Michigan	5%	5%	90%
Minnesota	12.5%	12.5%	75%
New York	25%	25%	50%
* According to a recent article in <i>State Tax Today</i> , the Illinois Legislature is considering returning to a three-factor double-weighted sales formula because of that state's budget problems.			

## FISCAL IMPACT

If the bill is amended to resolve the implementation considerations addressed in this analysis, the department's costs are expected to be minor.

## ECONOMIC IMPACT

### Revenue Estimate

The revenue impact of this bill is estimated to be as shown in the following table:

Estimated Revenue Impact of AB 2560 As Introduced February 21, 2002 Effective for income years beginning on or after January 1, 2002 Enacted after June 30, 2002 \$ Millions		
2002-03	2003-04	2004-05
-\$195	-\$255	-\$275

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

### Revenue Discussion

The revenue impact of this proposal would depend on the change in tax liabilities from the proposed apportionment formula as compared with current formula.

Samples of corporate tax returns for the tax years 1997, 1998, and 1999 were used for this analysis. For each corporation, tax liabilities under current and the proposed apportionment formula were computed. The revenue impact was estimated as the difference between the computed tax liabilities. The impact for each individual corporation was then statistically weighted and aggregated to derive an estimate of the total revenue impact for each of the above sampled tax years. It is assumed that 95% of corporations filing combined returns and having sale factors less than the averages of the other two factors would be required to use the single-factor formula based on sales. This assumption is based on an analysis of the relationship between California wages from the above 1997, 1998, and 1999 corporate samples. The revenue impact of the proposal was computed as the average of the above three estimates. The estimated impact was extrapolated into future years using the Department of Finance December-2001 projection of corporate taxable revenues.

### **LEGAL IMPACT**

There have been some concerns expressed in tax literature that a single-factor formula might be unconstitutional if done with the intent to benefit local commerce. In general, a single-factor sales formula would benefit companies that are physically located in one state to the detriment of those located outside that state. An equally weighted three-factor formula has been the bench mark to measure distortion, while a single-factor formula is more readily subject to distortions in the market and therefore more likely to be subject to litigation.

Further, requiring certain taxpayers that file a combined report to use the current three-factor, double-weighted sales formula, instead of the single-factor sales formula, could be subject to challenge since the requirement would not apply to apportioning taxpayers that are not members of a combined group.

### **ARGUMENTS/POLICY CONCERNS**

Unless a taxpayer is very static in its activity around the world, or its changes to California payroll and employees are always more significant than what is done elsewhere, taxpayers will likely fail the employment test that requires a two-year, state-by-state comparison of payroll and employees. In addition, taxpayers will likely pass the employment test that compares the average number of employees *everywhere* to 90% of the average number of employees in California during the preceding three years. However, the author might have intended to compare the average number of employees in California to 90% of the average number of employees in California during the preceding three years. Such a comparison would better test the loss of California jobs.

Current law provides an exception to the use of the three-factor, double-weighted sales formula for corporations that derive more than 50% of their gross business receipts from agricultural, extractive, savings and loan, and banking and financial business activities. These corporations are instead required to use a three-factor, single-weighted sales formula because of the adverse impact on those industries by a formula that weighs sales more heavily than other factors. Of the activities that currently receive an exemption from the more heavily weighted sales formula, this bill would provide an exception only for extractive activities.

Taxpayers that made a water's-edge election are bound by that election for seven years, unless the FTB permits a taxpayer to terminate an election under the water's edge regulations. Water's edge taxpayers could possibly use the change in the apportionment formula to try to terminate a water's-edge election.

"Guide to State Corporate Income Tax Apportionment – Part I," by James K. Smith (*Journal of Taxation*, Vol. 19, No. 1, Summer 2000) discusses the trend by states to increase the weight of the sales factor in apportionment formulas. According to the article, proponents of increasing the weight of the sales factor claim that a more heavily weighted sales factor will increase economic development within a state, is necessary to prevent property and payroll from leaving the state, and is more constitutionally sound than other tax incentives. Opponents of a more heavily weighted sales factor claim the altered apportionment formulas only result in short-term advantages to the state, unfairly create corporate winners and losers, and do a poor job of measuring the state's contribution to a corporation's income.

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